

OLD RECORD COPY

Civil Service Comm.

OLC 78-2271/1
15 June 1978

MEMORANDUM FOR: Comptroller
Director of Personnel

FROM

:

[REDACTED]
Acting Chief, Coordination and Review Staff
Office of Legislative Counsel

STAT

SUBJECT : OMB Issue Paper "The Income Base for Calculating
Federal Retirement Benefits"

1. This is for your information - no action is required.
2. The attached OMB issue paper was sent to Department of Defense, Civil Service Commission, and Department of State for comment and response, CIA is not involved. Bob Hull, Foreign Service Retirement Specialist at State alerted us to the paper and sent a copy.
3. I called Hilda Schreiber, Retirement Specialist at OMB, who for many years has been involved in CIARDS matters. She said this is a low level proposal prompted by OMB budget people. Schreiber said that the proposal to compute retirement annuities on the basis of career average wage would benefit low salaried employees who advance very little and employees who earn high salaries during all their careers. She said the proposal does not at this time have high level OMB attention as there are much more important considerations under review, such as combining Civil Service Retirement with Social Security. Schreiber said it would be quite some time before the over-all analysis is even undertaken.
4. Schreiber said she would keep us posted as to how this matter develops and strongly suggested that we "stay out of it" at this time.

STAT

Attachment:

As Stated

Distribution:

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OLC:PLC:jms (15 June 1978)

TO:

DATE: *June 19*, 1978

FROM:

OLC #78-2271

SUBJECT: The Income Base for Calculating Federal Retirement Benefits

As part of our annual internal budget review process, an issue paper was developed discussing the appropriate income base to be used for calculating Federal staff retirement annuities. As you know, most Federal retirement systems rely on the high average (such as the "high three" for the Civil Service Retirement System) or final salary as the income base to determine retirement benefits. The issue paper (Attachment A) describes possible inequities and inefficiencies of the current income bases and recommends an indexed career wage as a more appropriate income base.

The Director has agreed that OMB should conduct further analysis on the indexed career average approach (and alternative approaches) and report our results in the fall. We need your support in this effort. We would like your views on the original issue paper, your ideas on the best ways to further evaluate the alternative, and your estimate of costs to implement and support a revised income base measure.

Attachment B lists the information and analyses we would need under one approach for further analysis. In addition to your views on the issue and suggestions, we would also appreciate your best estimate as to the time and resources required to conduct the agency analyses and provide the data outlined in Attachment B.

In order to meet our deadline, we need your views by *June 15* ~~May~~ 31, 1978. (We do not want the sample data outlined in Attachment B at this time). After reviewing your response, together with those of other agencies, we will share with you the results of our review and discuss a plan for further analysis.

Attachments

SUBJECT A

Issue III-D

INEQUITABLE ASPECTS OF THE "HIGH AVERAGE OR FINAL SALARY" INCOME BASE
USED TO CALCULATE RETIREMENT BENEFITSStatement of Issue

Most Federal retirement programs rely on the high average (such as the "high-three" for civil service retirement) or final salary as the income base to calculate retirement benefits. Is this the best method of calculating retirement benefits and recognizing the important effects that inflation has on wage rates over the period during which retirement contributions are made?

Analysis

All Federal staff retirement systems use some form of the high average or final salary as the income base to determine retirement annuity benefits. In addition, State and local government retirement plans are overwhelmingly "final pay" plans. Although most private industry pension plans are not based on terminal salary levels, the trend has been strongly in this direction. A 1975 Bankers Trust Study found a continuing trend toward the "final average" approach: Over a 15-year period, the proportion of conventional plans (plans relating benefits to salary and service) using "final average" income bases rose from 55% to 78%.

The high average or final pay approach has been justified as a means of recognizing the effects of inflation on wage rates during the long periods over which contributions have been made to the retirement fund. Although many would agree to recognizing the impact of inflation, the use of high average or final pay is both an imprecise and -- in some cases -- discriminatory method that could be replaced by a price-indexed average career wage using the Consumer Price Index. This would accomplish the same goal with more precision and little, if any, discrimination.

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The high average or final income base is not necessarily an accurate reflection of the employee's value (to the employer) during his/her entire career because no fixed relationship exists between an employee's high average or final and career average pay.

The relationship between wages in the last few years of employment and wages over the entire career depends critically upon the work history. The three cases illustrated in Chart 1 represent workers with the same beginning and ending salary but different wage growth patterns. The "linear" case exhibits a constant 5% annual growth in salary. The "early riser" case exhibits a steadily declining growth rate, while the "late comer" has a steadily increasing growth rate. Workers with wage histories similar to that of the early riser receive disproportionately low retirement benefits relative to the benefits received by the others.

In Chart 2, present value ratios are compared for "typical" secretarial and professional general schedule wage histories. Since the secretarial wage history more closely resembles that of the "early riser" (than the "late comer") and the professional wage history resembles that of the "linear" case, the high-three income base discriminates in favor of the professional. Use of an indexed career average income base would eliminate this type of discrimination. In addition, a career average approach results in three desirable characteristics for retirement programs:

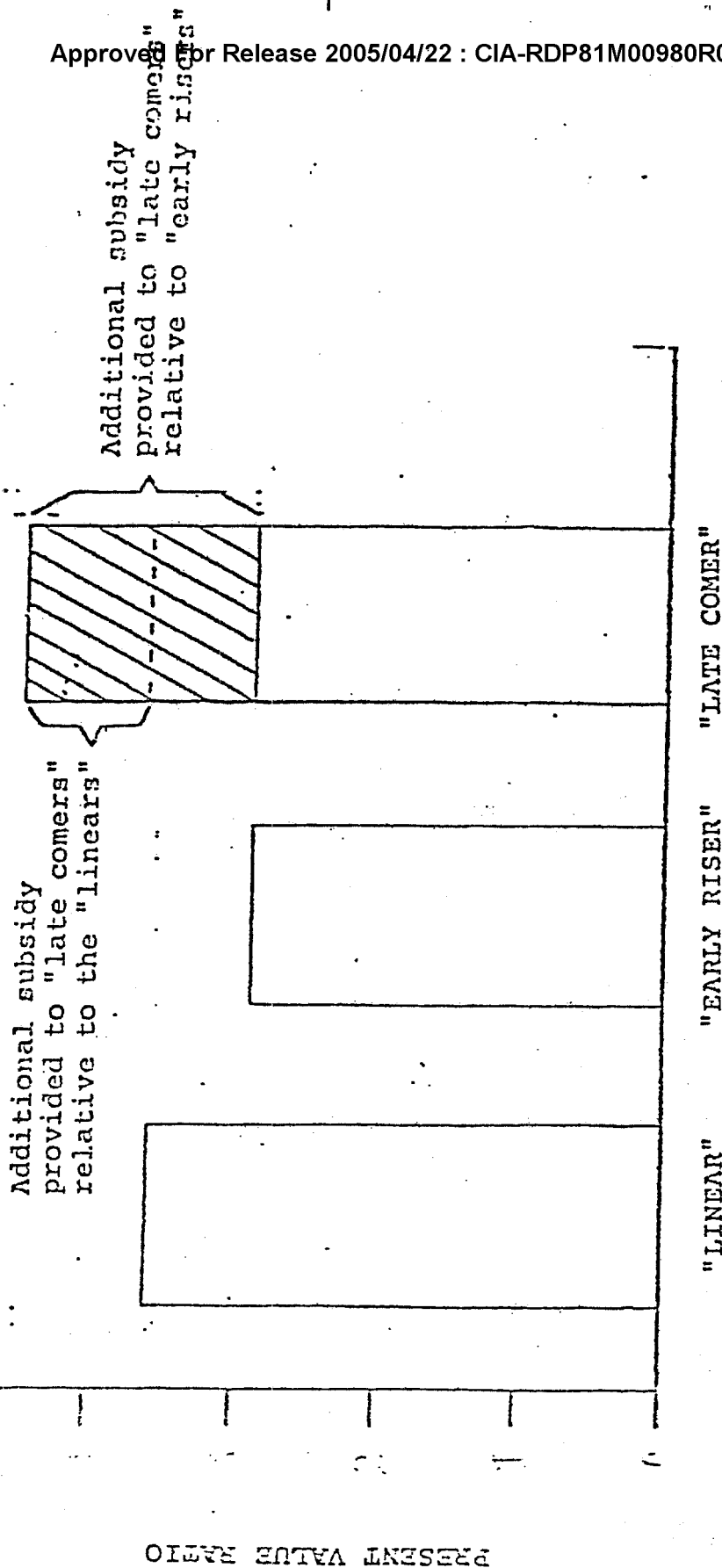
1. The retirement benefit level is related to the average value of the employee (to the employer) over the entire work career.
2. Because contributions under most Federal staff retirement plans are a fixed percentage of salary, the benefits are also related to the amount of (indexed) contributions made by the employee throughout his/her employment.
3. Because benefits would not be determined by the level of the final year salary (as is the case for several Federal staff programs), the strong incentive to "boof up" final salaries would be removed (for example, excessive overtime in the final year for law enforcement personnel).

In principle, the indexed career average income base is preferable to the high-three or any other "high average or final pay" income base. The primary complicating

factor is the data required to shift to such a base. Since wage histories would be required for each employee, additional data would have to be used by the employer to calculate the retirement benefit. Although the data do exist for the current work force, the Civil Service Commission has indicated that the data would have to be verified should such a change be made for current employees. The Commission does not foresee any serious difficulties in maintaining an appropriate data base to support the use of a career average wage base if the data base commences with current or future year pay data. A compensating adjustment would be required to the retirement benefit formula percentage factors (applied to years of service) to maintain unchanged average benefits.

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Present Value Ratio of Benefits to Contributions Under the
"High-Three Average" Income Base Measure



This chart depicts the relationship among the present value ratios of benefits to contributions for employees with three different career patterns. The linear wage history grows by a constant annual percentage. The "early riser" grows at a faster rate in the early stage of the career and at a slower rate in the later stage of the career. The reverse is the case for the "late comer". The shaded areas indicate the additional subsidy received by the late comer relative to the other cases.

ATTACHMENT B

Proposed Study Plan

Several analyses would be required for a complete evaluation of the proposal outlined in Attachment A. Agency contributions would include:

- . conducting some of the necessary analyses; and
- . providing data to OMB for use in other analyses.

The following information appears necessary for a complete evaluation.

Agency Analyses

1. The annual cost of maintaining a data base of employee wage histories sufficient to support the revised income base measure for your staff retirement system. For this purpose, assume that the base commences with future pay data and that the new income base is either:
 - a. An average based on annual wages earned by each employee throughout the employee's entire career in government service. Each year's wages would be indexed by the Consumer Price Index (CPI) based on the year in which the employee left government service; or
 - b. An average of the last 10 years of wages earned by each employee in government service. Each year's wages would be similarly indexed by the CPI.
2. If vested members of the system who leave government employment prior to eligibility for retirement had their average career wages (under the options listed above) indexed to the year in which they first receive retirement benefits, rather than the year in which they left government service, what would be the additional outlay cost to the retirement system?
3. What "percentage factors" would be required under the options listed above to maintain roughly the same annual outlays for retirement benefits under your staff retirement system. The current "percentage factors" for the major staff systems are as follows:

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Civil service:

- 1.5% x first 5 years of service
- 1.75 x second 5 years of service x income base
- 2.0% x remaining years of service

Foreign service:

- 2.0% x years of service x income base

Uniformed services:

- 2.5% x years of service x income base

Data Required for OMB Analyses

Two random samples of complete wage histories (of at least 20 years in length) for recent (within the last year or two) retirees would be needed, as described below.

Civil service and foreign service:

- Random sample of 25 secretarial and/or technical employees' wage histories.
- Random sample of 25 professional employees' wage histories.

Uniformed services:

- Random sample of 25 personnel wage histories.
- Random sample of 25 commissioned officers wage histories.

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